

# MINIMUM DISTRIBUTIONS OF CONTROLLED FOREIGN CORPORATIONS UNDER SECTION 963 OF THE INTERNAL REVENUE CODE

## INTRODUCTION

### *Pre-1962 developments: tax deferral and the rise of tax havens*

In the fifty-three years between 1909 and 1962, little change was made in the fundamental jurisdictional criteria for the taxation of the income of foreign corporations. Until 1962, it was generally true that a domestic corporation was taxed on a global or worldwide basis. Foreign corporations were taxed on income from "business transacted and capital invested within the United States."<sup>1</sup>

Under this jurisdictional pattern there was a significant difference in the tax treatment of the foreign branch of a United States enterprise and that of a foreign corporation owned or controlled by United States interests. A foreign branch of a United States enterprise was treated as a mere arm of the United States entity and its income was included in the income of the United States branch of the business. United States income taxes would be due on such income in the year of receipt.<sup>2</sup> On the other hand, a foreign corporation owned or controlled by United States interests, though analogous in function to a foreign branch, was treated like any other foreign corporation: It was taxed only on income derived from sources within the United States.<sup>3</sup> If the foreign corporation had no income derived from United States operations, it would pay no

---

<sup>1</sup> 36 Stat. 113 (1909).

<sup>2</sup> By the same token, any losses encountered by the foreign branch could be used to offset gains realized by the United States branch of the enterprise. Thus, if losses were anticipated in the initial years of foreign operations, a branch was often advisable for those years. Furthermore, such advantages as percentage depletion deductions, last-in-first-out inventory accounting methods, and accelerated depreciation were available for a branch operation. Brudno, "The Practical Aspects of Incorporating and Doing Business Abroad," U. So. Cal. 1959 Tax Inst. 345; Gilpin, "Form of Organization for Service and Contract Agencies Engaged in Operations Abroad," in *Taxation and Operations Abroad* 33, 35-37 (1960); Gilpin & Kern, "U.S. Tax Considerations Affecting Major Alternatives of Conducting Foreign Operations" in *2 Doing Business Abroad* 470, 471 (1962).

<sup>3</sup> Several attempts were made to give special treatment to foreign corporations controlled by United States interests in order to reduce the impact of a combination of foreign and United States taxes on these entities. Except for the foreign tax credit adopted in 1918 and the Western Hemisphere Trade Corporation provisions adopted in 1942, these attempts were either unsuccessful or insubstantial. Krause & Dam, *Federal Tax Treatment of Foreign Income* 27-29 (1964).

United States income tax until its foreign income was returned to the United States in the form of dividends, interest, or the proceeds of a sale.<sup>4</sup> This difference in tax treatment was unimportant before 1940 when the United States corporate tax rates were relatively low. Then, a United States entity contemplating foreign operations was normally more concerned with the foreign tax rate than the United States rate since the United States tax would probably be offset by the tax credit.<sup>5</sup> However, when United States tax rates approached or exceeded the foreign tax rates, the difference in treatment became significant. A United States corporation could obtain substantial tax advantages by conducting its foreign operations through a foreign corporation rather than through a foreign branch. United States income taxes on the earnings of a foreign subsidiary could be effectively deferred by not distributing earnings. Rather than return these earnings to the United States and subject them to United States taxes, management often decided to retain or reinvest them abroad, resulting in a permanent deferral of the United States tax. This tax deferral allowed a foreign subsidiary to acquire and accumulate capital at a more rapid rate than a foreign branch or a domestic corporation, with no risk of violating the accumulated earnings tax provisions being encountered.

Maximum tax benefits could often be achieved by taking advantage of a foreign tax haven. A tax haven is a country which imposes little or no income tax on a corporation's earnings outside the country of incorporation nor on the remittance of profits to the parent company as dividends.<sup>6</sup> A United States corporation could establish a subsidiary, called a base corporation, in such a haven, and carry on its foreign operations in other foreign countries. The profits from these operations would then be funneled into the base company by means of intercompany pricing arrangements and by shifting management fees and other corporate expenses.<sup>7</sup> "The object was to have as much profit as possible . . . fall into the foreign

<sup>4</sup> Gilpin, *supra* note 2, at 39-43.

<sup>5</sup> Moyer, "Operating a Corporate Enterprise Abroad," 1959 U. Ill. L.F. 271, 277.

<sup>6</sup> Gilpin, *supra* note 2, at 45.

<sup>7</sup> For a further discussion of methods and advantages of operating through a base company, see Gibbons, *Tax Factors in Basing International Business Abroad* 4-37 (1957); Krause & Dam, *op. cit. supra* note 3, at 13-19; Baker, "Methods and Channels of Foreign Trade," 1959 U. Ill. L.F. 142, 144-52; Brudno, *supra* note 2; Cherryman, "The New 'Subpart F' Foreign Income Provisions of the Internal Revenue Code," 4 W.&M. L. Rev. 172, 173 (1963); Gilpin, *supra* note 2, at 39-43; Gilpin & Kern, "Foreign Base Corporations—Their Use and Selection," in 2 *Doing Business Abroad* 533 (1962); Goeder & Wimmer, "Taxation Advantages and Problems in Foreign Trade," 1959 U. Ill. L.F. 202, 207-10; Gordon, "Some Aspects of United States Policy in the Taxation of Foreign Income," 1959 U. Ill. L.F. 222; Moyer, *supra* note 5, at 273-74.

base company. . . ."<sup>8</sup> Such profit could then be reinvested abroad in new operations, retained in the business, or allocated as needed among the various existing foreign operations without being passed through the United States parent or being subjected to the United States tax.<sup>9</sup>

This . . . [enabled] the . . . base corporation to operate simultaneously in several countries where tax rates at varying levels may be imposed and to minimize the effect of the per country limitation upon utilization of the foreign tax credit when dividends are paid to the parent and taxed in the United States.<sup>10</sup>

With these advantages available to a foreign subsidiary, but not to a foreign branch, it is not surprising that tax considerations were of paramount importance to the United States corporations or individuals planning to engage in foreign operations. In determining the form of business entity to be used abroad, tax considerations were often dispositive. The possibility of tax deferral often tipped the scale in favor of the foreign subsidiary as opposed to the foreign branch or direct exportation. The additional benefits of utilizing the tax haven device made it immensely popular among organizational planners.<sup>11</sup> By locating a base company in a country such

---

<sup>8</sup> Harris, "Foreign Base Companies Under the 1962 Act; Relief Provisions and Areas for Tax Planning," U. So. Cal. 1964 Tax Inst. 287, 288.

<sup>9</sup> Thus, in the period following World War II, there was a rapid increase in foreign investment. In the highly industrialized countries in which there had been substantial investment prior to World War II this increase was financed largely by earnings retained by the foreign corporations or from the local borrowings of foreign subsidiaries, rather than from a direct capital outflow from the United States. Moyer, *supra* note 5, at 277.

<sup>10</sup> Gilpin, *supra* note 2, at 45-46. Int. Rev. Code of 1954, § 904(a)(1), limits the credit for foreign taxes paid. The credit may be as to total tax liability proportionately no greater than the proportion which foreign source income bears to the taxpayer's entire taxable income. If a corporation's foreign source income is one-third of its total taxable income, the foreign tax credit available is limited to one-third of the United States income tax due. Treas. Reg. § 1.904-1(a) (1957) as amended, T.D. 6789, 1965 Int. Rev. Bull. No. 6, at 7. Cf. Proposed Treas. Reg. § 1.904-1(a)(1), 29 Fed. Reg. 7680-81 (1964). Under this section the foreign tax credit allowed may be considerably less than the foreign tax actually paid. Use of a base company may soften the impact of this provision. If the base company's income is composed of income from a corporation located in a country with a relatively high income tax rate and income from a corporation located in a country with a relatively low income tax rate, the combination of the foreign taxes paid by the base company in these two countries results in "an averaging process which usually reduces the adverse effect of the per country limitation otherwise operative." Gilpin, *supra* at 46. See also Gilpin & Kern, *supra* note 7, at 534-36.

<sup>11</sup> As pointed out in a symposium conducted by the Tax Institute in December of 1960, "there is relatively little . . . difference in the way a business is run—whether as a branch or as a subsidiary. . . . [S]ince the other costs are not affected

as Switzerland or Lichtenstein, a United States corporation could conduct extensive foreign operations with little or no tax expense.

THE KENNEDY ADMINISTRATION'S RECOMMENDATIONS ON  
THE TAX TREATMENT OF FOREIGN-SOURCE CORPORATE INCOME

*Policy considerations underlying the Kennedy recommendations*

Tax deferral undermines the maintenance of tax neutrality. There are two aspects to the concept of tax neutrality: domestic (export) neutrality and foreign (import) neutrality.

"Domestic neutrality implies equal treatment of Americans investing at home and Americans investing abroad."<sup>12</sup> When domestic neutrality is achieved the tax on the investment return is the same whether the income is derived from foreign or domestic sources. "As a result, the investor's choice between foreign and domestic investment will be free of tax considerations, as will his choice of alternative foreign investments."<sup>13</sup> As the preceding indicates, the prospect of tax deferral has a profound effect on both these choices. It places a premium on foreign investment as opposed to domestic investment, and the lure of the tax haven will effect the investor's choice of alternative foreign investments.

"Foreign neutrality implies equal treatment of Americans investing in foreign operations and their non-American competitors."<sup>14</sup> If foreign neutrality is achieved a United States citizen investing abroad will be able to compete on equal terms with other investors in the country where the investment is made. Barring special international agreements, the United States can afford foreign neutrality to United States taxpayers only by foregoing taxation of foreign-source income.<sup>15</sup> This would, in turn, frustrate the policy of assessing tax liability according to the taxpayer's ability to pay.

The two aspects of tax neutrality are mutually incompatible. If foreign neutrality is achieved, domestic neutrality is impossible.

and since the markets are not affected, a little difference in tax may have a big effect on the decision as to which type of arrangement to use." Blough, "General Analyses of Issues Facing Management," in *Taxation and Operations Abroad* 73, 78 (1960).

<sup>12</sup> Krause & Dam, *op. cit. supra* note 3, at 45; See Musgrave, "Criteria for Foreign Tax Credit," in *Taxation and Operations Abroad* 83, 84-85 (1960).

<sup>13</sup> Musgrave, *supra* note 12, at 84.

<sup>14</sup> Krause & Dam, *op. cit. supra* note 3, at 45. See Musgrave, *supra* note 12, at 85-86.

<sup>15</sup> Even this would only be true where the income of other foreign investors in the country of operations is tax exempt in *their* home country. To achieve complete foreign neutrality, the tax structure of the country of incorporation of every foreign corporation operating in the country of operations would have to be considered.

Tax deferral creates incentive for private foreign investment which may promote or subvert national policy goals. For example, in the period immediately following World War II, major United States foreign policy goals included the rebuilding of a war-torn and demoralized Europe. Private foreign investment was encouraged to accomplish this result, and, to the extent tax deferral provided an incentive for such investment, it augmented United States foreign policy. Today, foreign investment in underdeveloped countries may accelerate their economic development and promote political stability. Since this is also an avowed aim of United States policy, to the extent that tax deferral encourages investment in underdeveloped countries, it serves foreign policy.

When foreign investment is made in a country which is economically developed, no apparent foreign policy goal is furthered by the availability of tax deferral. In fact, to the extent that tax deferral encourages foreign investment which might otherwise be made domestically or encourages retention of foreign earnings abroad which might otherwise be repatriated, it may be detrimental to the domestic economy and the balance of payments.

During the post-World War II period when the United States was exporting huge amounts of capital to aid in the reconstruction of Europe, a favorable balance of payments was built up. Since the reconstruction of the European economy, and particularly with the advent of the European Common Market, the United States' export-import ratio has been declining until, as recent developments have dramatically illustrated, the current position of the United States balance of payments is cause for concern. In addition, as the demands of a continually increasing domestic population create further drains on United States resources, the United States is forced to rely more heavily on the importation of raw materials.<sup>16</sup>

The necessity of expanding our exports to pay for increased imports of raw materials may be as important to our national welfare as expanding the domestic market. Otherwise, we shall have to buy gold or further increase the already large dollar claims that the rest of the world has against this country.<sup>17</sup>

The three primary sources of capital outflow are expenditures for defense, foreign aid, and private foreign investments. "If . . . annual outflows for defense and aid are permanent, then our only refuge is to encourage exports. We have no other way of earning the money with which to pay for the indispensable imports."<sup>18</sup>

---

<sup>16</sup> Baker, "Tax and Management Decisions and Form of Business for Exporting," in *Taxation and Operations Abroad* 3, 5-11 (1960).

<sup>17</sup> *Id.* at 9.

<sup>18</sup> *Id.* at 11.

To the extent that tax deferral encourages private foreign investment and deters direct exportation, its effect on the balance of payments can be detrimental, especially if the return on the foreign investment is retained abroad. In this situation there is no subsequent capital inflow to offset the initial capital outflow created by the investment.

*The Kennedy Administration's recommendations*

On April 20, 1961, President Kennedy presented in a message to Congress his administration's tax recommendations for that year.<sup>19</sup> In referring to the policies underlying these recommendations, the President's message said:

Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system which, in conjunction with the tax systems of other countries consistently favor U.S. private investment abroad compared with investment in our own economy.<sup>20</sup>

In developing these recommendations the Administration considered several different objectives and goals. Since some of these objectives were in direct opposition to others, the proposals often pulled in different directions. For example, the Administration felt that tax considerations should play no part in determining the form of doing business abroad. Realizing the impossibility of achieving both foreign and domestic neutrality simultaneously and the undesirability of achieving foreign neutrality, the Administration took the position that the desirable goal was domestic neutrality.<sup>21</sup> Furthermore, tax deferral was felt to have a deleterious effect on the balance of payments due to the incentive it created for private

---

<sup>19</sup> Message of the President of the United States, Hearings Before the House Committee on Ways and Means on the President's 1961 Recommendations for Tax Revision, 87th Cong., 1st Sess., vol. 1, at 3 (1961) [hereinafter cited as H.R. Hearings].

<sup>20</sup> H.R. Hearings, vol. 1, at 8.

<sup>21</sup> Either we tax foreign income of U.S. companies at U.S. tax rates and credit the income taxes paid abroad, thereby eliminating the tax factor in the U.S. investor's choice between domestic and foreign investment; or we permit foreign investors to be taxed at the rates applicable abroad, thereby removing the impact, if any, which tax rate differences may have on the competitive position of the American investor abroad. Both types of neutrality cannot be achieved at once. I believe that reasons of tax equity as well as reasons of economic policy clearly indicate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad. Statement of C. Douglas Dillon before the House Committee on Ways and Means, H.R. Hearings, vol. 1, at 34.

foreign investment. The Administration's conclusion was that the elimination of tax deferral would help to achieve domestic neutrality and, to the extent that it discouraged foreign investment, would improve the balance-of-payments position.<sup>22</sup> Accordingly, among the 1961 recommendations was a proposal to eliminate tax deferral by imposing an immediate tax on the profits of foreign corporations controlled by United States interests, even if these profits remained undistributed.<sup>23</sup>

On the other hand, presumably due to the administrative problems that would be created in the case of publicly-held foreign corporations, the Administration felt that the elimination of tax deferral should not be applied to every United States shareholder of such corporations. Rather, it would apply only to those shareholders holding a substantial interest in a foreign corporation or to the shareholders of foreign corporations controlled by United States interests.<sup>24</sup>

Encouraging the development of underdeveloped countries was considered more important than achieving domestic neutrality. The complete elimination of tax deferral would discourage private foreign investment in developed and underdeveloped countries alike and undesirably retard the development of the latter. Therefore, the President recommended that the deferral privilege be retained for income originating in underdeveloped areas.<sup>25</sup>

Even underdeveloped countries provided no justification for permitting the tax haven device. On the theory that the use of tax havens upset the United States balance of payments and deferred investment in the United States, the President advocated

elimination of the tax haven device anywhere in the world, even in the underprivileged countries, through the elimination of tax deferral privileges for those forms of activities . . . . There is

---

<sup>22</sup> H.R. Hearings, vol. 1, at 9.

[E]limination of tax deferral in developed countries would have had two types of effects on our balance of payments. First, there would be smaller net outflows . . . as a consequence of the elimination of the tax inducement to send capital abroad. The second effect on the balance of payments from the elimination of tax deferral arises from the fact that there would no longer be a tax inducement to leave earnings abroad.

Statement of C. Douglas Dillon before the Senate Committee on Finance, "The Revenue Act of 1962," Hearings Before the Senate Committee on Finance, 87th Cong., 2d Sess., pt. 1, at 101 (1962) [hereinafter cited as S. Hearings].

<sup>23</sup> "Message of the President of the United States," H.R. Hearings, vol. 1, at 9.

<sup>24</sup> Detailed Explanation of the President's Recommendations Contained in His Message on Taxation, H.R. Hearings, vol. 1, at 261.

<sup>25</sup> Message of the President of the United States, H.R. Hearings, vol. 1, at 9.

no valid reason to permit their remaining untaxed regardless of the country in which they are located.<sup>26</sup>

In summary then, the main points of the President's recommendations with respect to the tax treatment of foreign income were: (1) elimination of tax deferral in developed countries through an immediate tax on undistributed profits of a foreign corporation; (2) retention of tax deferral for corporations in underdeveloped countries, and (3) complete elimination of tax havens.<sup>27</sup>

The Administration's proposals were met by a tremendous amount of opposition from the business and academic community. Although the use of the tax haven device was generally acknowledged as undesirable, the vast majority of the witnesses appearing before the congressional committees were opposed to the taxation of undistributed profits as a method of eliminating tax deferral.<sup>28</sup> Among reasons advanced in opposition to the taxation of undistributed profits were the following: There are often compelling business reasons for foreign investment other than tax considerations, and legitimate foreign business ventures should not be penalized because of the abusive practices of others;<sup>29</sup> the proposals would not

---

<sup>26</sup> *Ibid.*

<sup>27</sup> These proposals marked a significant reversal in governmental policy. Until this time it was generally agreed that the promotion of private foreign investment was a basic objective of the foreign economic policy of the United States. As late as 1959, Representative Boggs of Louisiana advocated creation of an entity to be known as a Foreign Business Corporation. Under his proposed bill a domestic corporation would qualify as a Foreign Business Corporation if it received 90% of its gross income from foreign sources and 90% of its gross income from the active conduct of a trade or business. Such a corporation would be subject to tax currently on its domestic income but could exclude its income from foreign sources until that income was distributed to its stockholders. It would be entitled to deferral of tax on its reinvested foreign-business income. Munsche, "The Boggs Bill: A Review of the Committee Print," 38 *Taxes* 11, 12 (1960). Also in 1959, C. Douglas Dillon, then Under Secretary of State, said that the promotion of private foreign investment was one of the three fundamental economic policies which provided the framework for dealing with international problems. Dillon, "United States Foreign Trade and Investment Policies," 1959 U. Ill. L.F. 107, 109. In fairness to Secretary Dillon it should be pointed out that he was not then speaking from a tax standpoint and his remarks were directed toward the development of underdeveloped countries, but less than two years appears to be a short time for a complete reversal of fundamental economic policy. Not even six months before the President's message, the General Counsel of the Department of Commerce and an Assistant Secretary of the Treasury viewed tax inducements (specifically tax deferral) as a desirable stimulus to foreign investment. See Dodds, "Tax Inducements as a Stimulus to Foreign Investment by United States Companies," in *Taxation and Operations Abroad* 232 (1960); Glasmann, "Tax Inducements to Stimulate Foreign Investment from Treasury Point of View," in *Taxation and Operations Abroad* 242 (1960).

<sup>28</sup> See generally H.R. Hearings and S. Hearings.

<sup>29</sup> Statement of Dan Throop Smith, H.R. Hearings, vol. 4, at 2590; S. Hearings,



substantially alter the balance of payments problem;<sup>30</sup> although foreign investment may be temporarily detrimental to the balance of payments, it is favorable in the long run, and unforeseen consequences could result from tampering with existing systems;<sup>31</sup> foreign investment is not an either-here-or-there proposition, but is made on the basis of sound business considerations;<sup>32</sup> foreign investment should be encouraged as it is essential that American business "get in" on European economic growth, which can only be done through foreign investment;<sup>33</sup> investment in the developed countries eventually works its way out to some degree to the underdeveloped countries;<sup>34</sup> foreign investors are forced to take risks to which domestic enterprises are not subject;<sup>35</sup> shareholders will not permit the indefinite retention of earnings overseas;<sup>36</sup> to tax income before it is actually received is not constitutionally justified;<sup>37</sup> and existing provisions of the Code could adequately deal with the tax haven problem.<sup>38</sup>

Finally, after eighteen months of hearing, drafting, amending, revising, and conferring, and after more than nine thousand pages of testimony had been taken, President Kennedy signed into law the Revenue Act of 1962.<sup>39</sup>

---

pt. 7, at 3089. The references in this and succeeding footnotes are random samplings and not meant to be exhaustive. Generally more than one witness would advocate more than one of the reasons set out in the text as justifying retention of tax deferral.

<sup>30</sup> Statement of Robert Anthoine, H.R. Hearings, vol. 4, at 3373-74; Statement of Leon H. Keyserling, S. Hearings, pt. 8, at 3315-18.

<sup>31</sup> Statement of Robert Anthoine, *supra* note 30, at 3373-74; Statement of Leon H. Keyserling, *supra* note 30, at 3315-18.

<sup>32</sup> Statement of Harold D. Arneson, H.R. Hearings, vol. 4, at 2848-49.

<sup>33</sup> Statement of Harold D. Arneson, *supra* note 32, at 2848.

<sup>34</sup> Statement of Harold D. Arneson, *supra* note 32, at 2848.

<sup>35</sup> Statement of Harold D. Arneson, *supra* note 32, at 2855.

<sup>36</sup> Statement of Harold D. Arneson, *supra* note 32, at 2851.

<sup>37</sup> Statement of Adrian A. Kragen, S. Hearings, pt. 7, at 3940; Statement of John L. Conolly, S. Hearings, pt. 7, at 2895.

<sup>38</sup> Statement of Fred W. Peel, H.R. Hearings, vol. 4, at 2618; Statement of John L. Conolly, S. Hearings, pt. 7, at 2896-97.

<sup>39</sup> The bill was introduced in the House on March 12, 1962. 108 Cong. Rec. 3809 (1962). It was reported out by the Committee on Ways and Means on March 16. 108 Cong. Rec. 4475 (1962). Debate in the House took place on March 28 and 29, and the House version of the bill was passed on March 29. 108 Cong. Rec. 5433 (1962). The Senate Committee on Finance reported the bill out on August 16. 108 Cong. Rec. 16722 (1962). Senate debate began in August 24 and the Senate version of the bill was passed on September 6. 108 Cong. Rec. 18743 (1962). The Conference Committee reported the bill out on October 1, and both Houses approved that version on October 2. 108 Cong. Rec. 21724-25, 21768 (1962). President Kennedy signed the bill into law on October 16. See Cherryman, *supra* note 7, at 173-75, for a more complete chronological history of the bill's passage through the two Houses of Congress.

SUBPART F—CONTROLLED FOREIGN CORPORATIONS<sup>40</sup>

Congressional response to the President's request for alteration of the tax treatment of foreign income became section 12 of the Revenue Act of 1962, which was codified into sections 951-72 of the Internal Revenue Code of 1954, as amended. These sections comprise Subparts F and G of Part III, Subchapter N of Chapter 1 of the Code. Subpart F constitutes a direct assault on the tax haven device.<sup>41</sup> The basic aim of the provisions of Subpart F can be quite simply stated: to eliminate the tax haven device through elimination of tax deferral in the developed countries, and at the same time to preserve tax incentives for the maintenance of foreign base companies in less developed countries.<sup>42</sup> But the statutory provisions and their accompanying regulations are "extremely technical and complex and do not easily lend themselves to summarization."<sup>43</sup>

Under the approach taken by Congress, a new category of corporate entity was created for tax purposes: the controlled foreign corporation. To qualify as a controlled foreign corporation, an entity must be organized outside the United States and United States shareholders must own more than fifty per cent of its total

---

<sup>40</sup> The following summary of the provisions of Subpart F is a general survey of the statutory provisions and does not purport to be a definitive analysis of their content. Its purpose is to provide a background for the discussion of section 963 which follows. For further discussion of the provisions of Subpart F and its accompanying regulations see S. Rep. No. 1881, 87th Cong., 2d Sess. 78-94 (1962); Cherryman, *supra* note 7; Fisher, "Proposed Regulations on Subpart F Income Reflect Cautious Treasury Approach," 18 J. Taxation 372 (1963); Hoefs & Bunge, "How to Minimize the Tax Impact on Foreign Operations Under the 1962 Act," 19 J. Taxation 346 (1963); Hoefs & Bunge, "Tax Considerations Involved in International Business Under the 1962 Revenue Act," 19 J. Taxation 294 (1963); Hughes "First Foreign Income Regulations Are Adopted: Do They Exceed the Intent of the Statute?" 20 J. Taxation 24 (1964); McDonald, "Controlled Foreign Corporations," in 5 Institute on Private Investments Abroad 5 (1963); Miles, "How 'Foreign Base Company Sales Income' Treatment Can Be Avoided," 17 J. Taxation 355 (1962); Naylor & Huber, "Analysis of Proposed 'Tax Haven' Legislation," 39 Taxes 1006 (1961); Nicholson & Hoefs, "1962 Act: Radical Changes Require Immediate Re-examination of Foreign Activities," 17 J. Taxation 348 (1962); Phelps, "How Minimum Distributions Can Reduce Tax on Subpart F Income," 17 J. Taxation 356 (1962); Saltzman, "Undistributed Income Subject to 'Taint' of Subpart F is Spelled out by Final Regulations," 21 J. Taxation 110 (1964); Slowinski, "Foreign Income Provisions of H.R. 10650," U. So. Cal. 1963 Tax Inst. 109; Comment, "Qualified Investment in Less Developed Countries Under The Revenue Act of 1962," 18 U. Miami L. Rev. 675 (1964).

<sup>41</sup> S. Rep. No. 1881, 87th Cong., 2d Sess. 79 (1962).

<sup>42</sup> Harris, "Foreign Base Companies Under the 1962 Act; Relief Provisions and Areas for Tax Planning," U. So. Cal. 1964 Tax Inst. 287.

<sup>43</sup> Nicholson & Hoefs, *supra* note 40, at 348.

voting stock at least one day during its taxable year.<sup>44</sup> A United States shareholder is defined as a United States person owning at least ten per cent of the corporation's total voting stock.<sup>45</sup> Therefore a foreign corporation becomes a controlled foreign corporation for the year if, on any day during that year, more than fifty per cent of the corporation's voting stock is owned by five or fewer United States persons, provided that each of them owns at least ten per cent of the corporation's total voting stock.<sup>46</sup> In determining whether or not a foreign corporation qualifies as a controlled foreign corporation and whether or not a United States person qualifies as a United States shareholder, stock ownership is to be attributed to a person whether he owns it directly, indirectly, or constructively.<sup>47</sup> The rules of section 318(a) generally apply for the purpose of determining if stock is owned constructively.<sup>48</sup> Indirect ownership of a foreign corporation's stock occurs where, by virtue of an interest in an intermediate entity, a United States person is considered owner of a proportionate share of the corporation's stock.<sup>49</sup> Consider, for example, a domestic corporation, *A*, holding eighty per cent of the one class of stock of foreign corporation *B*, which in turn owns sixty per cent of the one class of stock of foreign corporation *C*. In determining whether or not corporation *A* is to be considered a United States shareholder with respect to corporation *C*, whether or not corporation *C* is a controlled foreign corporation, the domestic corporation, *A*, will be found to own forty-eight per cent of corporation *C* because of *A*'s proportional ownership of *B*'s ownership of *C*.

The shareholders of a foreign corporation which qualifies as a controlled foreign corporation for thirty consecutive days during the tax year may be subject to the operative provisions of Subpart F. A proportionate share of certain types of income must be included in the year's gross income by each United States shareholder owning stock in the corporation on the last day of the taxable year that it qualifies as a controlled foreign corporation. Even though no distribution has in fact been made, the shareholder must include

---

<sup>44</sup> Int. Rev. Code of 1954, § 957(a). Sections 957(b) and 957(c) set out certain exceptions to this general rule where the corporation engages in the insurance of United States risks or is organized in Puerto Rico or a United States possession and meets certain other definitional requirements.

<sup>45</sup> Int. Rev. Code of 1954, § 951(b).

<sup>46</sup> A United States person includes a United States citizen, resident, partnership, corporation, estate, or trust, with minor modifications. Int. Rev. Code of 1954, §§ 957(d), 7701(a) (30).

<sup>47</sup> Int. Rev. Code of 1954, § 958.

<sup>48</sup> Int. Rev. Code of 1954, § 958(b).

<sup>49</sup> Int. Rev. Code of 1954, § 958(a) (2).

the income in his gross income just as if it had been distributed.<sup>50</sup> Three types of undistributed income must be so included: (1) the United States shareholder's pro rata share of the corporation's Subpart F income for that year, (2) the shareholder's pro rata share of previously excluded Subpart F income which has been withdrawn from investment in less developed countries during the year, and (3) the shareholder's pro rata share of the increase in corporate earnings invested in United States property during the year, but this latter type of income is includable only to the extent that it is not otherwise included in the United States shareholder's gross income.<sup>51</sup> Only income attributable to stock owned directly or indirectly need be included in the United States shareholder's gross income. Constructively owned stock is treated as being actually owned for the purpose of identifying a controlled foreign corporation and determining United States shareholder status; however, it is not so treated in determining the United States shareholder's share of the controlled foreign corporation's Subpart F income which must be included in the United States shareholder's gross income.

Thus, before undistributed profits of a foreign corporation may be taxed under Subpart F, three conditions must be met: (1) The corporation must be a controlled foreign corporation, (2) for thirty consecutive days during the year, and (3) Subpart F income must be realized.

### *Subpart F income*

Subpart F income is divided into two categories: income derived from the insurance of United States risks, and foreign base company income.<sup>52</sup> Foreign base company income is further broken down into three subclasses: foreign personal holding company income, foreign base company sales income, and foreign base company services income.<sup>53</sup>

### *Foreign personal holding company income*

Though this income has nearly identical characteristics with that described in the foreign personal holding company provisions of the Code,<sup>54</sup> some differences occur respecting income received from rents, from the active conduct of a trade or business, and from

---

<sup>50</sup> Int. Rev. Code of 1954, § 951(a).

<sup>51</sup> Int. Rev. Code of 1954, § 951(a).

<sup>52</sup> Int. Rev. Code of 1954, § 952(a).

<sup>53</sup> Int. Rev. Code of 1954, § 954(a).

<sup>54</sup> Int. Rev. Code of 1954, §§ 551-57.

related persons.<sup>55</sup> This type of income was included in Subpart F income because it was felt that no policy justification could be found for deferral of tax on passively received investment income or income from portfolio-type investments.<sup>56</sup>

### *Foreign base company sales income*

Foreign base company sales income results from a transaction in which a foreign base company, either directly or on behalf of a related person, acts as an intermediary in the purchase, sale, or purchase and sale of personal property.<sup>57</sup> The statutory provisions and the examples set out in the regulations make it clear that the transaction contemplated is one involving three countries and three corporations—the typical tax haven transaction.<sup>58</sup> Thus, where controlled foreign corporation *A* in country *X* purchases goods from an unrelated person in country *Y* and sells them to related person *B* in country *Z*, any income on the sale realized by controlled foreign corporation *A* is foreign base company sales income. The same result obtains if controlled foreign corporation *A* in country *X* purchases personal property from related person *B* in country *Z* and sells it to an unrelated person in country *Y*. If, however, the property involved in the sale originated in or is to remain in the controlled foreign corporation's country of incorporation, the income realized on the sale is not foreign base company sales income.<sup>59</sup> Thus, if controlled foreign corporation *A* in country *X* purchases personal property produced in country *X*, no foreign base company sales income is realized on a later sale of the property. By the same token, if a controlled foreign corporation in country *X* sells personal property for use or consumption in country *X*, no foreign base company sales income is realized.

Foreign base company sales income can also be avoided if the property which is the subject of the sale is manufactured or produced by the controlled foreign corporation itself.<sup>60</sup> If the character of the property purchased by the controlled foreign corporation is substantially altered by manufacture prior to sale, the property will be treated as having been produced or manufactured by the con-

---

<sup>55</sup> A related person is an individual, partnership, trust, or estate which controls the controlled foreign corporation; a corporation which controls, or is controlled by, the controlled foreign corporation; or a corporation controlled by the same person or persons which control the controlled foreign corporation. Int. Rev. Code of 1954, § 954(d) (3).

<sup>56</sup> S. Rep. No. 1881, 87th Cong., 2d Sess. 83 (1962).

<sup>57</sup> Int. Rev. Code of 1954, § 954(d).

<sup>58</sup> Treas. Reg. § 1.954-3 (1963).

<sup>59</sup> Treas. Reg. §§ 1.954-3(a) (2), (3) (1963).

<sup>60</sup> Treas. Reg. § 1.954-3(a) (4) (i) (1963).

trolled foreign corporation. No foreign base company sales income will be realized on the sale.<sup>61</sup> "[T]he theory [is] that the same property . . . has not been resold if it has gone through a manufacturing process which makes it substantially different property."<sup>62</sup> Thus, controlled foreign corporation *A* in country *X* can purchase personal property such as wood pulp from a related person in country *Y*, convert it to another form, such as paper, and sell it in country *Z* without realizing any foreign base company sales income.

### *Foreign base company services income*

Foreign base company services income is derived from the controlled foreign corporation's performance of technical, managerial, engineering, commercial, or similar services for or on behalf of a related person outside the country of incorporation.<sup>63</sup>

### *Limitations and exclusions*

Several limitations and exclusions contained in Subpart F restrict or negate the operation of section 951. In defining foreign base company income, section 954 specifically excludes certain income received as a return on investments in less developed countries,<sup>64</sup> and income from the use of aircraft or vessels in foreign commerce.<sup>65</sup> Moreover, if foreign base company income comprises less than thirty per cent of the controlled foreign corporation's gross income, it is

---

<sup>61</sup> Treas. Reg. § 1.954-3(a)(4)(ii) (1963).

<sup>62</sup> Harris, *supra* note 42, at 302.

<sup>63</sup> Int. Rev. Code of 1954, § 954(e).

<sup>64</sup> Int. Rev. Code of 1954, § 954(b)(1). This exclusion, though at odds with the statutory goal of eliminating tax deferral, is consistent with foreign policy considerations underlying the bill. In exempting from Subpart F treatment the income from a qualified investment in a less developed country, Congress intended to preserve any pre-1962 incentive for capital movement to underdeveloped countries. One writer has concluded that the opposite result has been effected, and investment in less developed countries has actually been impeded as a result of the 1962 act. Popkin, "Less Developed Countries and the Revenue Act of 1962," 40 Ind. L.J. 1 (1964). The President is given authority to designate which countries are to be considered less developed under Subpart F, though some developed countries are specifically enumerated by § 995(c)(3). By Exec. Order No. 11071, 27 Fed. Reg. 2875 (1962), President Kennedy designated (with the exception of Spain) every country in the world not specifically excluded as a less developed country. The result is that all of Latin America, virtually all of Africa, and all of non-communist Asia is within the less developed classification. Subpart F will have no effect in these areas, leaving the tax haven device still available in such Latin American countries as Panama. Upon withdrawal of Subpart F excluded income from the less developed country in which the qualified investment has been made, with certain limitations it will be includible in the United States shareholder's gross income for the year in which it was withdrawn. Int. Rev. Code of 1954, §§ 951(a)(1)(A)(ii), 951(a)(3).

<sup>65</sup> Int. Rev. Code of 1954, § 954(b)(2).

not to be treated as foreign base company income.<sup>66</sup> Deductions are permitted from Subsection F income to the extent they can be attributed to that income.<sup>67</sup> Finally, where it is established to the satisfaction of the Secretary that the creation of the controlled foreign corporation did not have the effect of substantial reduction of income or similar taxes, income received by the corporation is not included in foreign base company income.<sup>68</sup>

A further exclusion is found in section 952(b) which provides that Subpart F income does not include United States-source income of a foreign corporation which is engaged in a trade or business in the United States if such income was otherwise includible in the United States shareholder's gross income. The object of this section is to avoid the possibility of double taxation with respect to such income. Without this provision, both the controlled foreign corporation and the United States shareholder would pay a tax on the same dollar in the same year.

Section 951(a)(2) provides a further limitation on the realized Subpart F income which is includible in gross income. To be included is the amount which the United States shareholder would have received if, on the last day it qualified as a controlled foreign corporation during the year, the corporation had distributed an amount bearing the same proportionate relationship to its total Subpart F income as the part of the year that the corporation qualified as a controlled foreign corporation bears to the total taxable year. Thus, when a corporation qualifies as a controlled foreign corporation for one-half of the taxable year, the United States shareholder must include in his gross income his proportionate share of one-half of the corporation's Subpart F income. The amount to be included in the shareholder's gross income is to be reduced by any amount actually received as a dividend by any other person, if that distribution bears to the total Subpart F income the same relationship as the part of the year in which the shareholder did not own the stock bears to the entire year.

## MINIMUM DISTRIBUTIONS

### *Theory of the minimum distribution*

What may well become the most important method of avoiding the impact of Subpart F is found in section 963. If the total foreign and United States taxes paid on an actual dividend distribution

---

<sup>66</sup> Int. Rev. Code of 1954, § 954(a)(3)(A). On the other hand, § 954(b)(3)(B) provides that if the foreign base company income exceeds 70% of the controlled foreign corporation's gross income, all gross income is to be treated as base company income.

<sup>67</sup> Int. Rev. Code of 1954, § 954(b)(5).

<sup>68</sup> Int. Rev. Code of 1954, § 954(b)(4).

approximate the United States tax which would otherwise be due, the advantages of tax deferral are eliminated. In such a case there will be no incentive to obtain tax deferral and there will be no necessity to tax the controlled foreign corporation's remaining undistributed profits.<sup>69</sup>

These considerations led Congress to enact "one of the most complex schemes ever to be devised in the history of tax legislation."<sup>70</sup> Under section 963, if a certain percentage of the controlled foreign corporation's earnings and profits are actually distributed, no amount of its income need be included as Subpart F income in the gross income of a United States corporate shareholder. A table is provided for use in correlating this required percentage with the combined foreign and United States tax rates.<sup>71</sup> Broadly stated, no part of the controlled foreign corporation's income need be included in the United States shareholder's gross income if the total of the United States and foreign taxes paid or accrued amount to approximately ninety per cent of the United States taxes which would otherwise be due. Thus, the statutory percentage of earnings and profits which must be distributed to qualify decreases as the effective foreign tax rate increases. Where the effective foreign tax rate is under nine per cent, the minimum distribution must be eighty-three per cent of the controlled foreign corporation's earnings and profits in order to qualify under section 963. Conversely, no distribution is required if the effective foreign tax rate at least is forty-three per cent. While the provisions of section 963 can easily be applied to a single isolated transaction, their application to a complex multicorporate transaction presents problems so formidable that Congress left their solution to the Treasury Department.<sup>72</sup>

---

<sup>69</sup> McDonald, *supra* note 40, at 11.

<sup>70</sup> Cherryman, "The New 'Subpart F' Foreign Income Provisions of the Internal Revenue Code," 4 W.&M. L. Rev. 172, 202 (1963).

<sup>71</sup> Int. Rev. Code of 1954, § 963(b). The table referred to throughout this comment is found in § 963(b)(3), and is applicable to years beginning after December 31, 1964.

<sup>72</sup> As one author has pointed out:

One of the biggest problems with respect to applying section 963 is that of computing the earnings and profits for foreign tax purposes. This task is complicated enough for domestic corporation situations. In CFC situations there must be superimposed many other factors, such as depreciation calculations on foreign assets . . . the gyrating rates of foreign currency exchange; consolidated returns . . . the variegated types of foreign reserve accounts, some of them secret; the blocked foreign income exemption found in section 964(b); the possible election to take up sales income in installments; differing foreign accounting methods, and the foreign language from which all this must be translated. Code section 963(f) leaves to the Treasury Department the chore of weaving these threads into an intelligible pattern, including providing "regulations for the determination of the amount of



The Treasury has now promulgated regulations which attempt to meet these problems.<sup>73</sup> Predictably, the new regulations are lengthy, technical, and extremely complex. They are intended to perform a variety of functions: defining of terms, setting out the procedure for making an election under section 963, prescribing the method for determining the minimum amount which must be distributed to qualify as a minimum distribution, and determining what type of distributions will count toward a minimum distribution.<sup>74</sup>

### *Types of elections*

The provisions of section 963 are permissive and they are available only to the taxpayer who complies with the Treasury's terms as set out in the regulations. If these terms are met, four distinct alternatives are available to a United States corporate taxpayer faced with the prospect of United States income taxation on undistributed profits of a controlled foreign corporation. First, it may elect to exclude from its gross income the Subpart F income of any single controlled foreign corporation in which it owns stock directly.<sup>75</sup> Second, it may elect to exclude the Subpart F income of any series of foreign corporations which contains no more than one corporation not a controlled foreign corporation.<sup>76</sup> Third, it may elect to exclude the Subpart F income of any group of foreign corporations which includes all of the controlled foreign corporations in which the United States shareholder directly or indirectly owns stock.<sup>77</sup> Finally, the United States shareholder may make a section 963 election to exclude amounts otherwise includable in gross income by virtue of stock ownership, direct or indirect, in a controlled foreign corporation if the stockholder's ownership is in a less-developed-country corporation.<sup>78</sup>

The first mentioned alternative above is called a first-tier election.<sup>79</sup> Under this type of election, if a United States corporate

---

foreign tax credit in the case of distributions with respect to the earnings and profits of two or more foreign corporations."

Cherryman, *supra* note 70, at 202-03.

<sup>73</sup> Treas. Reg. §§ 1.963-1 to -7 (1964), as amended, T. D. 6767, 1964 Int. Rev. Bull. No. 47, at 68-72. The amendment was promulgated in order to make certain minor or technical amendments, and, therefore, will not hereinafter be cited in conjunction with Treas. Reg. § 1.963 (1964).

<sup>74</sup> Treas. Reg. § 1.963-1(a) (1) (1964).

<sup>75</sup> Int. Rev. Code of 1954, § 963(c) (1).

<sup>76</sup> Int. Rev. Code of 1954, § 963(c) (2).

<sup>77</sup> Int. Rev. Code of 1954, § 963(c) (3).

<sup>78</sup> Int. Rev. Code of 1954, § 963(c) (4) (A).

<sup>79</sup> Treas. Reg. § 1.963-1(c) (1) (i) (a) (1964).

shareholder owns stock directly in one or more controlled foreign corporations, it may make an election under section 963 with respect to the stock owned in any one of these corporations or any combination thereof.<sup>80</sup>

The second alternative, called a chain election, is more complicated since it involves a more complex corporate scheme. The chain election allows a United States shareholder that holds stock in one or more controlled foreign corporations indirectly to avail himself to an exclusion under section 963 with respect to the income of these corporations.<sup>81</sup> If the shareholder is deemed to have an interest in more than one chain, the election is permissible with respect to any one of the chains, or any combination thereof. For example, suppose domestic corporation *A* owns stock directly in controlled foreign corporation *B*. Suppose further that corporation *B* owns stock of controlled foreign corporation *C*, which in turn owns stock in controlled foreign corporation *D*. If domestic corporation *A* owns stock in controlled foreign corporation *E*, which in turn also owns stock in controlled foreign corporation *D*, there are two chains of ownership, each having corporation *A* at its head: chain *A-B-C-D* and chain *A-E-D*. If the holdings are sufficiently large to make domestic corporation *A* a United States shareholder with respect to all these corporations, corporation *A* would have to include in its gross income its proportionate share of the Subpart F income of these corporations. Under section 963 corporation *A* can exclude some or all of this income from its gross income by electing to receive a minimum distribution from either one or both complete chains or from a segment of either or both chains so long as none of the links in any one chain is skipped.<sup>82</sup>

The third type of election available to the United States corporate shareholder is the group election.<sup>83</sup> It allows the shareholder to make the 963 election to exclude from gross income the proportionate share of the earnings of controlled foreign corporations in

---

<sup>80</sup> Treas. Reg. § 1.963-1(c)(1)(i)(a) (1964). Thus, if a domestic corporation is a United States shareholder with respect to controlled foreign corporations *A*, *B*, and *C*, a first-tier election can be made in the following combinations: *A* only; *B* only; *C* only; *A* and *B*; *A* and *C*; *B* and *C*; or *A*, *B*, and *C*.

<sup>81</sup> Treas. Reg. § 1.963-1(c)(1)(i)(b) (1964). By implication the regulations provide that the election is not available if more than one of the corporations in the chain is not a controlled foreign corporation. Treas. Reg. § 1.963-1(e)(1) (1964).

<sup>82</sup> Possible combinations would include the following: *B* and *C*; *B*, *C*, and *D*; *E* and *D*; or *B* and *C* as one chain and *E* and *D* as another chain. While the regulations do not specifically provide for it, no objection appears to a chain election with respect to corporations *B* and *C*, or *B*, *C*, and *D*, and a first-tier election with respect to controlled foreign corporation *E*.

<sup>83</sup> Treas. Reg. § 1.963-1(c)(1)(ii) (1964).

which it owns stock either directly or indirectly, and of all foreign corporations, controlled or noncontrolled, through which the United States shareholder indirectly holds stock in a controlled foreign corporation.<sup>84</sup> If a group election is made, foreign branches of the United States shareholder may be included in the group and be treated as wholly-owned subsidiaries of the shareholder which subsidiaries have made a full distribution of earnings and profits to the United States shareholder during the year.<sup>85</sup>

The fourth possible election is a variant of the group election. In effect a group election is made, but controlled foreign corporations which qualify as less-developed-country corporations under section 955 need not be included in the group.<sup>86</sup>

### *The required amount*

Section 1.963-2 of the regulations sets out the method for determining the amount which must be distributed in order for the distribution to qualify as a minimum distribution. The first step in this determination is the computation of the United States shareholder's effective foreign tax rate with respect to the corporation or corporations in connection with which the election is made. After the effective foreign tax rate is determined, reference to the table in section 963(b) reveals the statutory percentage of the controlled foreign corporation's earnings and profits which must be distributed to meet the requirements of section 963. Applying this percentage to the earnings and profits of the corporations for which the election is made produces the dollar amount of the distribution which qualifies as a minimum distribution under section 963.

Two factors are considered in the determination of the effective foreign tax rate: the United States shareholder's proportionate share of the foreign corporation's foreign income taxes for the year,<sup>87</sup> and the United States shareholder's proportionate share of the foreign corporation's earnings and profits for the year.<sup>88</sup> The effective foreign tax rate is computed as follows: First, the sum of the United States shareholder's proportionate share of the foreign income taxes of the chain or group and the United States shareholder's propor-

---

<sup>84</sup> A foreign corporation may be excluded from a group election if it is established that a minimum distribution cannot be made due to the currency or other limitations imposed by the law of a foreign country. Treas. Reg. § 1.963-1(f)(3) (1964).

<sup>85</sup> Treas. Reg. § 1.963-1(f)(4) (1964).

<sup>86</sup> If a group election is made and such corporations are excluded from the group, a first-tier election cannot be made with respect to such corporations. Treas. Reg. § 1.963-1(f)(1) (1964).

<sup>87</sup> Treas. Reg. § 1.963-2(e)(1) (1964).

<sup>88</sup> Treas. Reg. § 1.963-2(d) (1964). The computation of the minimum distribution is based on a percentage of the foreign corporation's total earnings and profits, not just the earnings and profits which constitute Subpart F income.

tionate share of the foreign corporation's earnings and profits is found. Then the percentage which the United States shareholder's proportionate share of the foreign income taxes bears to the sum thus arrived at, is found. This percentage is the effective foreign tax rate.<sup>89</sup> Thus, if the United States shareholder's proportionate share of the foreign income taxes of the foreign corporation is thirty dollars, and the United States shareholder's proportionate share of the foreign corporation's earnings and profits is seventy dollars, the sum of the two will be one hundred dollars and the United States shareholder's effective foreign tax rate with respect to the foreign corporation is thirty per cent.  $[30/(70+30)]$ .<sup>90</sup>

In section 1.963-4 of the regulations, the Treasury Department has set out special rules to be observed when a chain or group election is made. They establish the method for computing the minimum overall tax burden that will enable a distribution to qualify as a minimum distribution under section 963. While these special rules appear to go beyond the scope of the statutory provisions, their validity will probably be immune to attack since they are obviously aimed at a possible method of avoiding both the tax and the minimum distribution envisioned by Subpart F. The statutory provisions suggest the possibility of making a chain or group election in such a way as to combine income from a corporation in a country with a relatively high income tax rate and income from a corporation in a country with a relatively low income tax rate. Such a combination will reduce the effect of Subpart F and could conceivably permit a type of averaging of the foreign income taxes of the two countries and result in complete avoidance of tax which would otherwise be due. For example, suppose domestic corporation *A* owns all of the stock of controlled foreign corporation *B* which has income of 1,000 dollars and is incorporated in a country with a forty-seven per cent income tax rate. Suppose further that corporation *A* owns all of the stock of controlled foreign corporation *C* which has income of one hundred dollars and is incorporated in a country with a three per cent income tax rate. A first-tier election with respect to these corporations will result in a required distribution of eighty dollars.<sup>91</sup> However, if a group election is made with respect to these corporations, all of the Subpart F income allocable

---

<sup>89</sup> Treas. Reg. § 1.963-2(c) (1964).

<sup>90</sup> This percentage is then applied to the table in § 963(b) to determine the percentage of earnings and profits which must be distributed to qualify as a minimum distribution. In the example given above, the percentage of earnings and profits which must be distributed to obtain an exclusion under § 963 is 89%.

<sup>91</sup> Controlled foreign corporation *B* need not make any distribution since its effective foreign tax rate (47%) is greater than 43%. To qualify for exclusion, corporation *C* must make a distribution of 83% of \$97, or \$80.

to the United States shareholder's interests can be excluded from the United States shareholder's gross income and no minimum distribution will be required.<sup>92</sup>

To prevent this, section 1.963-4 of the regulations provides that, even if a distribution is made which would quantitatively qualify as a minimum distribution for the chain or group, no exclusion will be allowed unless one of three alternative tests is met.

The first alternative test, the ninety per cent rule, is that the sum of the United States and foreign income taxes paid or accrued by the chain or group with respect to the distribution in question must equal or exceed a specified minimum. This minimum equals ninety per cent of the product of the following multiplication: The sum of the foreign income taxes and the consolidated earnings and profits of the chain or group times the percentage which equals the sum of the normal tax rate and the surtax rate.<sup>93</sup> If this minimum is met, the total United States and foreign taxes paid with respect to the distribution will be within ten percentage points of the United States tax which would be due under Subpart F on the earnings and profits of the chain or group if no distribution had been made. Thus, this requirement supports the statutory aim of exempting undistributed Subpart F income from taxation if the taxes already borne by such income approximate the United States tax which would be paid absent deferral.

The second alternative test for allowing exclusion is satisfied where the distribution qualifies as a pro rata distribution and the special rules of sections 1.963-4(b) and 1.963-4(c) of the regulations are met.<sup>94</sup> A pro rata distribution occurs when the amount distributed is allocated according to the statutory percentage of the earnings and profits of each foreign corporation in the chain or group.<sup>95</sup> Thus, suppose the statutory percentage of the earnings and profits which must be distributed in order to qualify as a minimum distribution is sixty-nine per cent of the earnings and profits of the chain or group. Foreign corporations *A*, *B*, *C*, and *D*, as members of the chain or group, must *each* contribute sixty-nine per cent of their individual earnings and profits to the distribution in order that it may qualify as a pro rata minimum distribution. It is not enough that the total distribution is adequate to meet the sixty-nine per cent requirement; the percentage requirement must be met with respect to each corporation in the chain or group.

---

<sup>92</sup> Combining the United States and foreign income taxes of the two corporations results in an effective foreign tax rate of 43%.

<sup>93</sup> Treas. Reg. § 1.963-4(a)(1)(i) (1964). Foreign income taxes deemed paid under § 904(d) are not included. Treas. Reg. § 1.963-4(a)(2)(ii) (1964).

<sup>94</sup> Treas. Reg. § 1.963-4(a)(1)(ii)(a) (1964).

<sup>95</sup> Treas. Reg. § 1.963-4(a)(2)(i) (1964)

The third alternative test is met by reducing the amount of the allowable foreign tax credit on the income involved in the distribution and by complying with the special rules of section 1.963-4(b) and 1.963-4(c) of the regulations.<sup>96</sup> In effect, the allowable foreign tax credit must be reduced to the extent necessary to make the overall United States and foreign taxes paid in connection with the distribution equal or exceed the lesser of the total taxes which would be paid or accrued using one of the two preceding tests. Thus, the allowable foreign tax credit must be reduced until the overall United States and foreign income taxes deemed paid with respect to the distribution equal the amount of the United States and foreign taxes which would be due if a pro rata distribution was made, or the total must equal at least ninety per cent of the United States tax which would otherwise be due if the earnings and profits of the chain or group were not distributed.

It is readily apparent that these three tests are alternative routes to the same ultimate goal which underlies the entire framework of section 963. Meeting these requirements means that either each corporate member of the chain or group must disgorge the statutory percentage of earnings and profits as dividends, thus eliminating the averaging effect, or the total United States and foreign taxes paid will approximate the United States tax which would otherwise be due on the foreign corporation's income. If any one of these tests is met, tax deferral is effectively eliminated.

### *Special rules*

Section 1.963-4(b) of the regulations sets out special rules for determining the earnings and profits and the foreign income taxes of foreign corporations in a chain or group. The provisions of this paragraph fall into three general divisions. They provide first that foreign income taxes of a foreign corporation are to be taken into account in determining the effective foreign tax rate only if they are not included in the foreign tax credit for the year.<sup>97</sup> Secondly, if one or more foreign corporations, including branches treated as foreign subsidiaries, suffers a deficit during the taxable year, this deficit is to be ratably allocated throughout the other foreign corporations in the chain or group; the United States shareholder's proportionate share of the earnings and profits of each foreign corporation in the chain or group is to be proportionately reduced.<sup>98</sup> The third subparagraph of this section provides that where distributions are made successively through a chain or group, the

---

<sup>96</sup> Treas. Reg. § 1.963-4(a)(1)(ii)(b) (1964).

<sup>97</sup> Treas. Reg. § 1.963-4(b)(1) (1964).

<sup>98</sup> Treas. Reg. § 1.963-4(b)(2) (1964).

amounts so distributed will be considered to have been received from the earnings and profits of the *distributing* corporation and allocated to the earnings and profits of the recipient corporation. When the recipient corporation then makes a distribution, that distribution will be deemed to come from the earnings and profits of the first corporation.<sup>99</sup> For example, suppose that controlled foreign corporation *B* receives a dividend of sixty dollars from controlled foreign corporation *C*, which dividend would count toward a minimum distribution. Suppose further that corporation *B* distributes a dividend of fifty dollars to corporation *A*. If corporations *B* and *C* are in a chain for which a 963 election is made by corporation *A*, the entire fifty dollars distributed by corporation *B* will be deemed to have come from the sixty dollars received from corporation *C*. Corporation *B* will not be considered to have made any distribution of its earnings and profits which can be counted toward a minimum distribution.

Perhaps the most formidable problem to be encountered under section 963 is that of determining the amount of the foreign tax credit for distributions involving two or more foreign corporations. Congress considered this problem to be so difficult that its solution was specifically left to the Secretary to be resolved in the regulations.<sup>100</sup> The Treasury Department's response to this statutory mandate is section 1.963-4(c) of the regulations, easily the longest and most complicated section of a thoroughly complex scheme. This paragraph provides that, where a chain or group of foreign corporations is involved, the United States shareholder's foreign tax credit with respect to a minimum distribution is to be determined the same way that a regular foreign tax credit is determined under sections 901-05, but with the five following modifications.

First, when a United States shareholder receives a distribution of the earnings and profits of a second-tier foreign corporation which have been "passed through" a first-tier foreign corporation, the foreign income taxes paid by the second-tier corporation are not averaged with the earnings and profits of the first-tier corporation, the usual method under section 902(b). Rather, they are passed through the first-tier corporation at their full dollar-for-dollar value.<sup>101</sup>

Second, foreign income taxes paid by the foreign corporation on its earnings and profits which are used for the minimum distribution to the United States shareholder are to be kept separate from

---

<sup>99</sup> Treas. Reg. § 1.963-4(b) (3) (1964).

<sup>100</sup> Int. Rev. Code of 1954, § 963(f).

<sup>101</sup> Treas. Reg. § 1.963-4(c) (1) (i) (a) (1964).

the foreign income taxes paid on other earnings of the foreign corporation.<sup>102</sup>

Third, a deficit of another corporation in the chain or group reduces a United States shareholder's proportionate share of the earnings and profits of another foreign corporation belonging to the chain or group. In this situation no foreign tax credit is applicable to the amount distributed by the profitable corporation to the extent that the amount distributed exceeds the shareholder's reduced proportionate share of the earnings of the distributing corporation.<sup>103</sup> For example, suppose that the United States shareholder's proportionate share of the earnings and profits of a foreign corporation has been reduced to fifty dollars because of a deficit for that year in another corporate member of the chain or group. If the distribution of the corporation's earnings and profits for that year is sixty dollars, no foreign tax credit is available for taxes paid on the last ten dollars of the distribution because to that extent the distribution exceeds the United States shareholder's proportionate share of the earnings and profits of the corporation. Without this provision, no United States tax is due in a situation where the losses of one corporation offset the gains of another corporation, and there are no consolidated earnings and profits taxable under a group election. Yet the profitable corporation could claim a foreign tax credit which could be carried over into succeeding years.

Fourth, the United States shareholder may reduce the foreign tax credit and defer the amount of the reduction to another year by following subparagraph (c)(3) of section 1.963-4 which, by reference to paragraph (a)(1)(i)(b) of section 1.963-4, operates in the following manner: The section 901 foreign tax credit applicable to the distribution is reduced by the amount necessary to make the year's total of United States and foreign taxes on the income involved in the distribution equal or exceed a calculated minimum. This minimum is the lesser of (a) the total of the United States and foreign income taxes which would be paid in the event a pro rata distribution is made, or (b) ninety per cent of the amount arrived at by multiplying the sum of the earnings and profits and the consolidated foreign income taxes of the corporation times a percentage equal to the sum of the normal tax rate and the surtax rate. The amount of the foreign tax credit which is disallowed can then be deferred until distribution of the remaining profits earned during the taxable year in question. At that time, the deferred tax credit is applied ratably against such earnings and profits. Thus, if a group election is made and part of the earnings and profits of the

---

<sup>102</sup> Treas. Reg. § 1.963-4(d)(1)(i)(b) (1964).

<sup>103</sup> Treas. Reg. § 1.963-4(c)(1)(i)(c) (1964).



foreign corporations are distributed in a manner which does not meet the ninety per cent requirement [without applying the special rules of paragraphs (b) and (c)], or does not qualify as a pro rata distribution, some of the foreign tax credit may not be available to the United States shareholder. However, the amount not allowed can be deferred until an additional portion of the heretofore undistributed earnings and profits are distributed.<sup>104</sup>

Finally, the special foreign tax credit rules provide that the grossing-up provisions of section 78 are not applicable in determining the foreign tax credit allowable with respect to the minimum distribution.

*Corporations in countries with variable tax rates*

The foreign income tax may vary with the proportion of the corporation's earnings and profits which are distributed; *e.g.*, undistributed profits may be taxed at one rate while distributed profits are taxed at another rate. This situation occasions slightly different treatment under section 963 in the case of single first-tier corporations or corporations in a chain or group whose minimum overall tax burden is determined by the special rules of section 1.963-4(b) and -4(c) of the regulations. This modified treatment occurs when a pro rata distribution is made or when the foreign tax credit is reduced. The effective foreign tax rate is determined as follows: If the United States shareholder receives its proportionate share of the earnings and profits which are actually distributed by the foreign corporation, the foreign income tax on the pretax and predistribution earnings and profits is to be determined as if the foreign corporation had made no distributions during the year.<sup>105</sup> However, the United States shareholder may not actually receive its proportionate share of the distributed earnings and profits of the foreign corporation, where, for example, a distribution received by a first-tier foreign corporation is not "passed through" to the United States shareholder. Then, in determining the effective foreign tax rate, the corporation's foreign income tax on its pretax and predistribution earnings and profits will be considered equal to the foreign income tax which actually was due in light of the distributions which were actually made.

---

<sup>104</sup> There is a possibility that all, or at least part, of the deferred credit can be irretrievably lost. One limitation placed on the use of the deferred credit is that the amount of the credit for the year is not to exceed the tax for the year and no carry-back or carry-over is available with respect to the deferred tax credit. Thus, if the United States shareholder's tax due on the proceeds of the distribution is exceeded by the sum of the foreign tax credit available to reduce taxes on the earnings and profits for the current year plus the amount of the available deferred tax credit, the excess is unavailable and cannot be deferred until a later date.

<sup>105</sup> Treas. Reg. § 1.963-5 (1964).

If the foreign tax on undistributed profits is higher than the tax on distributed profits, to the extent that distributions are actually made, this section may work to the advantage of the United States shareholder. For example, take the case of a second-tier corporation in a country which taxes undistributed earnings and profits at a rate of fifty per cent and taxes distributed earnings and profits at a rate of twenty per cent. If this corporation has earnings and profits of one hundred dollars which it retains, or if they are distributed to a first-tier corporation which retains them, the foreign income tax actually due will be fifty dollars. This figure will also be used in determining the effective foreign tax rate of the chain or group of which the second-tier corporation is a member where an election under section 963 is made. If, on the other hand, the one hundred dollars is distributed to a first-tier corporation, which in turn distributes it to the United States shareholder, the foreign tax *actually due* will be twenty dollars. However, for the purpose of determining the effective foreign tax rate, fifty dollars is still considered the amount of the foreign tax which has been paid.<sup>106</sup>

This differential could become significant in determining the minimum which must be distributed to qualify for a section 963 minimum distribution exclusion; a variance in the effective foreign tax rate could produce a different statutory minimum percentage. Unfortunately for the taxpayer, this is a one-way street. For if the foreign taxes on earnings and profits increases as distributions are made, for example, as when the foreign tax rate on distributed profits is higher than the foreign tax rate on undistributed profits, the general rule applicable to foreign corporations in countries having variable tax rates will apply. The provision for using the actual foreign tax due is specifically made available only where "the United States shareholder owns the stock . . . in such corporation by reason of stock owned through a chain of ownership . . . and the foreign income tax of such corporation for the taxable year *decreases* as distribution are made from its earnings and profits."<sup>107</sup> The following example illustrates this provision. A second-tier corporation operating in a country which taxes undistributed earnings and profits at a rate of twenty per cent and distributed profits at a rate of fifty per cent has earnings of one hundred dollars. These earnings may be retained or distributed to a first-tier corporation which retains them. The foreign income tax due will be twenty dollars, the amount also used in determining the effective foreign tax rate under section 963. Conversely, the second-tier corporation distributes the one hundred dollars to the first-tier corporation, and the latter in turn distributes them to the United States shareholder,

<sup>106</sup> Treas. Reg. § 1.963-5(b) (1964).

<sup>107</sup> Treas. Reg. § 1.963-5(b) (1964). (Emphasis added.)

the foreign tax actually due will be fifty dollars. However, for the purpose of determining the effective foreign tax rate, the foreign income tax on pretax and predistribution earnings and profits will be determined under section 963 as though the foreign corporation made no distributions for the taxable year.

This appears to be a curious result if the statutory goal was to discourage foreign investment or, in the alternative, to encourage repatriation of capital through the use of minimum distributions. To the extent that the total foreign and United States tax burden on each distributed dollar exceeds the total United States tax burden on each retained dollar, there is incentive to retain the earnings in the foreign corporation, optimal tax treatment can then be achieved by paying the foreign tax, including the income in gross income under Subpart F, and utilizing the foreign tax credit provisions. Where the foreign tax rate on distributed profits exceeds the United States tax rate there is no incentive at all to make any distributions whatsoever. To distribute the earnings could result in an effective foreign tax rate lower than the foreign taxes actually paid. Thus, to qualify for an exclusion under section 963, a larger distribution must be made than would otherwise be necessary.

Section 1.963-5 of the regulations also prescribes the method to be used by a foreign corporation in a country with variable tax rates when the minimum distribution necessary to qualify for an exclusion under section 963 is being computed.<sup>108</sup> Three specific types of situations are described: a distribution by a single-tier corporation, a pro rata distribution by a corporation in a chain or group, and a non-pro rata distribution by a corporation in a chain or group. The method of computation is similar in all three situations. Such a corporation must minimally distribute an amount found by multiplying the statutory percentage of earnings and profits which must be distributed to qualify as a minimum distribution, times the United States shareholder's proportionate share of the earnings and profits of the corporation, chain, or group, and then reducing this product by the foreign income tax which would be paid or accrued on the pre-United States tax amount. This last amount is determined by multiplying the statutory percentage times the United States shareholder's proportionate share of the earnings and profits less such foreign taxes. Thus, in computing the amount of the distribution that will qualify for an exclusion under section 963 where the foreign corporation is in a country where the income tax rates vary according to the distributions made, the procedure is as follows: (1) determine the statutory percentage of earnings and profits which must be distributed to qualify for exclusion as a

---

<sup>108</sup> Treas. Reg. § 1.963-5 (1964).

minimum distribution by determining the effective foreign tax rate and applying the table in section 963(b), (2) determine the United States shareholder's proportionate share of the earnings and profits of the foreign corporation, (3) multiply the statutory percentage by the United States shareholder's proportionate share of the corporation's earnings and profits, (4) determine the foreign income taxes which would be due on that amount if it were distributed, and (5) deduct from the amount in item (3), the foreign income taxes which would be due on that amount. The remainder is the amount which will qualify as a minimum distribution.

### *Deficiency distributions*

If, by a closing agreement; an agreement between the district director and the shareholder; a decision of the Tax Court; or a final order, judgment, or decree of any court of competent jurisdiction, it is determined that a United States shareholder failed to receive an amount which was sufficient to qualify as a minimum distribution, and that such failure was due to reasonable cause,<sup>109</sup> the shareholder can receive a deficiency distribution which will count toward the distribution which was inadequate as a minimum distribution.<sup>110</sup> In order to count toward a minimum distribution, the deficiency distribution must, to the extent possible, be made from the earnings and profits of the corporation for the year in which was made the distribution which was intended as a minimum distribution. The deficiency distribution will be treated as having been received by the United States shareholder in that year.

### ALTERNATIVE ELECTIONS UNDER SECTION 963: A CASE STUDY

The following examples partially illustrate the preceding commentary by describing several different alternatives available to the United States shareholder in the same hypothetical factual situation.<sup>111</sup>

*Facts:* Corporation *A* is a domestic corporation with substantial foreign holdings. It owns eighty per cent of the one class of stock

<sup>109</sup> Reasonable cause will be found if the United States shareholder receives 80% of the amount which would be required to qualify as a minimum distribution and there is no evidence of bad faith. If less than 80% of the amount which would qualify as a minimum distribution is received, the taxpayer must demonstrate reasonable cause by clear and convincing evidence. Treas. Reg. § 1.963-6(b)(4) (1964).

<sup>110</sup> Treas. Reg. § 1.963-6 (1964).

<sup>111</sup> The complexity of the subject matter precludes a single illustration's embodying every aspect of the minimum distributions provisions. Among the topics not treated in the examples are the allocation of deficits among a chain or group, the possibility of treating foreign branches as subsidiaries, and deficiency distributions.

of controlled foreign corporation *B*. The latter corporation, *B*, owns sixty per cent of the one class of stock of controlled foreign corporation *C*, which in turn owns eighty per cent of the one class of stock of controlled foreign corporation *D*. Corporation *A* also owns five per cent of the one class of stock of foreign corporation *E*, not a controlled foreign corporation. Corporation *E* owns eighty per cent of the one class of stock of controlled foreign corporation *F*, which in turn owns seventy-five per cent of the one class of stock of controlled foreign corporation *G*. Corporation *C* also owns the twenty per cent of the one class of stock of corporation *F* not held by corporation *E*. None of the foreign corporations qualify as less developed country corporations or have any blocked foreign income. Each of the foreign corporations has pretax and predistribution earnings and profits of one hundred dollars exclusive of any dividends received. Each of the controlled foreign corporations has Subpart F income which would be includible in the gross income of a United States shareholder.

The foreign corporations are subject to foreign income taxes at the following rates: corporation *B* at five per cent of earnings and profits, corporation *C* at thirty per cent of earnings and profits, corporation *D* at forty-five per cent of earnings and profits, corporation *E* at twenty per cent of earnings and profits, corporation *F* at forty per cent of earnings and profits, and corporation *G* at forty per cent of undistributed earnings and profits and twenty per cent of distributed earnings and profits.

Each foreign corporation makes a distribution from earnings and profits for the current taxable year in the following amounts: corporation *B*, thirty dollars; corporation *C*, sixty dollars, corporation *D*, forty dollars; corporation *E*, one hundred dollars; corporation *F*, sixty dollars; and corporation *G*, forty dollars.

If corporation *A* wishes to exclude some or all of the foreign corporations' Subpart F income from its gross income by electing to receive a minimum distribution under section 963, various alternatives are possible. The following discussion illustrates them.

#### *First-tier election*

Corporation *B* is the only corporation with respect to which corporation *A* can make a first-tier election.<sup>112</sup> The amount to be distributed to qualify as a minimum distribution is computed as follows:

---

<sup>112</sup> A first-tier election can be made only with respect to a controlled foreign corporation in which the United States shareholder owns stock *directly*. Treas. Reg. § 1.963-1(d)(i) (1964). Corporation *A* owns stock directly only in corporations *B* and *E*. Since a United States shareholder is a United States person who owns at least 10% of the voting stock of a controlled foreign corporation and corporation *A*

a. Determination of the effective foreign tax rate: <sup>113</sup>	
(1) Determination of corporation <i>A</i> 's proportionate share of corporation <i>B</i> 's earnings and profits: <sup>114</sup>	
Pretax and predistribution earnings and profits . . . . .	\$100.00
Dividends received . . . . .	60.00
	<hr/>
Pretax earnings and profits . . . . .	\$160.00
Less: Foreign income taxes paid or accrued . . . . .	8.00
	<hr/>
Earnings and profits . . . . .	\$152.00
Corporation <i>A</i> 's proportionate share of corporation <i>B</i> 's earnings and profits. (.80 x 152) . . . . .	\$121.60
(2) Determination of corporation <i>A</i> 's proportionate share of corporation <i>B</i> 's foreign income taxes: <sup>115</sup>	
Corporation <i>A</i> 's proportionate share of corporation <i>B</i> 's foreign income taxes (.80 x 8) . . . . .	\$ 6.40
(3) Determination of the effective foreign tax rate:	
Effective foreign tax rate [6.40/(121.60 + 6.40)] . . . . .	5%
b. Statutory percentage under section 963(b)(3) . . . . .	83%
c. Required amount of minimum distribution to qualify for exclusion. <sup>116</sup>	
Required minimum distribution (.83 x 121.60) . . . . .	\$100.93
Less: Distributions already made (.80 x 30) <sup>117</sup> . . . . .	24.00
	<hr/>
Amount which remains to be distributed by corporation <i>B</i> in order to qualify as a minimum distribution	<u>\$ 76.93</u>

### *Chain election*

If corporation *A* elects to make a chain election there are several alternatives available. Such an election can be made for any combination of one or more of corporations *B*, *C*, *D*, *E*, *F*, and *G*,

owns only 5% of the stock of corporation *E*, corporation *A* is not a United States shareholder with respect to corporation *E* and need not include in its gross income any Subpart F income of corporation *E* not attributable to dividends received by corporation *E* from a controlled foreign corporation. However, the fact that corporation *A* is not a United States shareholder with respect to corporation *E* does not mean that it is not a United States shareholder with respect to second-tier corporations in a chain in which corporation *E* forms a link. For example, by virtue of its 5% interest in corporation *E*, corporation *A* indirectly owns 4% of the voting stock of corporation *F*. By virtue of its 80% interest in corporation *B*, corporation *A* indirectly owns 48% of the voting stock of corporation *C*, which indirectly makes corporation *A* the owner of an additional 9½% of corporation *F*. Combining this with the 4% owned through corporation *E* makes corporation *A* a United States shareholder with respect to corporation *F*, and, indirectly, of corporation *G*. If corporation *A* decides to make a first-tier election, only the Subpart F income of corporation *B* can be excluded. The Subpart F income of the other controlled foreign corporations must be included in corporation *A*'s gross income.

<sup>113</sup> Treas. Reg. § 1.963-2(c)(1) (1964).

<sup>114</sup> Treas. Reg. § 1.963-2(d) (1964).

<sup>115</sup> Treas. Reg. § 1.963-2(e)(1) (1964).

<sup>116</sup> Treas. Reg. § 1.963-2(a) (1964).

<sup>117</sup> Corporation *A* received 80% of the \$30 distributed by corporation *B*.

with the following limitations: First, if corporation *C* is included in a chain, corporation *B* must also be included; second, if corporation *D* is included in a chain, corporation *C* must be included; third, if corporation *F* is included in a chain, either corporation *E* or corporation *C* must also be included; finally, if corporation *G* is included in a chain, corporation *F* must also be included.

Because of the similarity in computing the minimum distribution in the case of both chain and group elections, the computation of the minimum amount required to be distributed in the event of a chain election will not be illustrated.

### *Group election*

If, under a group election, the special rules of regulation's paragraphs 1.963-4(b) and (c) are not applied, section 1.963-4(a) (1)(i) defines the minimum qualifying distribution. It must be such that the overall United States and foreign tax burden is at least ninety per cent of this product: The sum of the consolidated earnings and profits and consolidated foreign income taxes of the group times the added percentages of the United States normal tax and surtax rates. Thus, if corporation *A* should make a group election under this provision and then also apply the taxes on intercorporate dividends to the determination of the effective foreign tax rate—rather than toward the minimum distribution—a minimum possible distribution for exclusion would be computed as follows: [See Exhibit A]

If corporation *A* receives 66.99 dollars in additional distributions from the earnings and profits of the group, it can exclude from its gross income the Subpart F income of the group. That will make the total distributions from the earnings and profits of the group equal 95.99 dollars. The overall United States and foreign income tax burden on such distribution (102.16 dollars) exceeds the minimum overall tax burden of 84.32 dollars.

The minimum qualifying pro rata distribution occurs when each foreign corporation distributes the statutory percentage of its earnings and profits equivalent to a minimum distribution. In the event of a pro rata minimum distribution, it is proper to apply the special rules of regulations section 1.963-4, which concerns the determination of earnings and profits and the foreign tax credit with respect to the United States shareholder. Should corporation *A* elect to receive a pro rata minimum distribution from the group the amount of the distribution would be computed as follows: the amount of the distribution would be computed as follows: [See Exhibit B]





Comparison of this result with that in the preceding illustration shows that significant tax differences can be obtained by different elections made by a United States shareholder. It also emphasizes the importance of making a thorough analysis of the tax consequences before any distribution is made by a foreign corporation. In the preceding illustration a further distribution of 66.99 dollars would have satisfied the minimum distribution requirement. It could have been made by any of the corporations or from any combination of them. In the case of a pro rata distribution the United States shareholder must receive specific additional distributions aggregating 86.69 dollars from specific corporations in order to receive a qualifying pro rata distribution. Furthermore, the amounts indicated are the amounts which the United States shareholder must receive from each corporation respectively, not the amount which the corporation itself must distribute. For example, in order for the United States shareholder to receive the necessary sixty-nine cents from corporation *D*, corporation *D* must make a total distribution of 1.79 dollars; in order for the United States shareholder to receive the necessary forty-four cents from corporation *E*, corporation *E* must make a total distribution of 8.80 dollars.

The regulations permit a United States shareholder to elect to make a distribution qualify as a minimum distribution by reducing its allowable foreign tax credit for the current year.<sup>130</sup> The tax credit reduction must be sufficient to make the overall United States and foreign income taxes deemed paid for the year equal to or greater than the lesser of: (1) the overall United States and foreign income taxes which would be paid or accrued if a pro rata distribution were made, or (2) ninety per cent of the United States tax which would be due on the sum of the consolidated earnings and profits and foreign income taxes of the group. The reduction in the foreign tax credit can then be deferred to subsequent years. The amount of the reduction is allocated among first- and second-tier corporations only.<sup>131</sup>

Paragraph (c)(3) of section 1.963-4 of the regulations illustrates the method for making such an election. The following is a sample computation of a reduction in the foreign tax credit made with such an election. For the purpose of this illustration the facts used in the preceding examples will be the same except that it is assumed that no distributions are made by any of the corporations other than as indicated below. The operation of section 1.963-4(a)(1)(ii)(b) would be as follows: [See Exhibit C]

---

<sup>130</sup> Treas. Reg. § 1.963-4(a)(1)(ii)(b) (1964).

<sup>131</sup> Treas. Reg. § 1.963-4(c)(3)(ii) (1964).

The overall United States and foreign income taxes with respect to the distribution are less under the ninety per cent rule (84.33 dollars) than they would be if a pro rata distribution were made (91.46 dollars). If the group makes a distribution which does not qualify as a pro rata distribution, the foreign tax credit for the group must be reduced to the extent necessary to make the overall United States and foreign income taxes with respect to the distribution equal the overall United States and foreign taxes deemed paid if the ninety per cent rule were applied.

For example, if corporation *A* receives dividends of seventy dollars from corporation *B*, thirty dollars from corporation *C*, and fifteen dollars from corporation *D*, the total distribution (115 dollars) would exceed the amount equal to the product of the statutory percentage and the consolidated earnings and profits with respect to corporation *A* (112.31 dollars), but corporation *A* must make such a reduction in the foreign tax credit allowable that the overall United States and foreign income taxes for the year with respect to the distribution equal the overall United States and foreign taxes paid if the ninety per cent rule were applied—or 84.33 dollars. The computation would be as follows: [See Exhibit D]

The 8.90 dollars of the foreign tax credit which was deferred will be allocated to the remaining income of corporations *B* and *C* in the ratio which the United States shareholder's proportionate share of the remaining earnings and profits of each such corporation for the taxable year bears to the United States shareholder's total proportionate share of the combined earnings of corporation *B* and corporation *C* for the year. If these earnings are distributed in subsequent years, the proportionate amount of the foreign tax credit which has been deferred will then be available.

### CONCLUSION

Section 963 represents one of the most complex and ingenuous concepts in the history of tax legislation. Originally intended as a method of reducing the effect of the other sections of Subpart F, it may prove to be a highroad to their complete avoidance. American business will undoubtedly continue to expand internationally and section 963 may become the most important single section of Subpart F for the United States corporate taxpayer with substantial foreign holdings.

Although the problems anticipated are formidable enough, application of these provisions to complex multicorporate relationships spanning several national boundaries may create problems undreamed of by the statutory draftsmen. The special rules concerning treatment of the foreign tax credit superimpose further problems on an area which was complicated enough at the outset, and controversies will certainly arise in this area. As the provisions are applied to complex multicorporate relationships clarification will be required in some areas. Attempts to correlate the United States tax system with those of other countries may create an administrative nightmare. What is to be done in a situation involving a tax system like Belgium's, for example, in which a percentage of the tax paid on undistributed profits is refunded upon the distribution of the profits in a subsequent year?<sup>141</sup> While the regulations suggest that this would be proof of reasonable cause for a deficiency distribution, it still creates further problems in the treatment of the foreign tax credit, especially if the amount of the credit has been reduced and the reduction deferred. At the very least it means that, for an uncomfortably indefinite period, the taxpayer's returns will be subject to the probability rather than the possibility of change and recomputation.

---

<sup>141</sup> Foreign Tax Law Association, 1965 Belgian Income Tax Service, art. 126.

One particularly troublesome problem is the possibility of a United States person who really has almost no control over the foreign corporation's activities but who qualifies as a United States shareholder with respect to a controlled foreign corporation. The provisions of Subpart F were aimed at the tax haven device, which implies that the entity is dominated and under the control of the United States shareholders. Their application to a United States person who does not have such control appears to be a spurious method of reaching a desired goal.<sup>142</sup> This is illustrated in the examples given in the preceding material. Under the facts given, domestic corporation *A* qualified as a United States shareholder with respect to controlled foreign corporation *F* although it is quite possible that corporation *A* had no voice in corporation *F*'s affairs. This would mean that corporation *A* would be forced to include a proportional share of corporation *F*'s Subpart F income in its gross income even though it was against corporation *A*'s best efforts that the earnings remained undistributed. It would also mean that corporation *A* would be effectively precluded from making an election under section 963 unless corporation *F* should decide to make a distribution which would qualify as a minimum distribution independently of any efforts corporation *A* might make. Corporation *A* could not force corporation *F* to make such a distribution.

Finally, the complexity of the provisions may result in their being applied most frequently against taxpayers who believe that they have effectively avoided Subpart F, resulting in uneven and arbitrary enforcement.<sup>143</sup>

*Fredrick O. Jolley*

---

<sup>142</sup> The concept of a controlling U.S. group is a keystone of this legislation because without the U.S. group, potentially able to "control" or compel the distribution of the "undistributed" earnings to be subject to tax to the U.S. shareholders, the legislation as an income tax . . . would outrage the traditional sense of fair play. Unfortunately, the U.S. group, although meeting the legislative text [*sic*] of "control," might not, in fact, "control" the foreign corporation in any practical sense.

McDonald, "Controlled Foreign Corporation," in 5 Institute on Private Investments. Abroad 5, 9 (1963).

<sup>143</sup> *Id.* at 8.